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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-1202

VINCENT F. CHIARELLA,

Petitioner,

against

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER

Opinions Below

The opinion of the United States Court of Appeals for the Second Circuit (Appendix A to Chiarella's petition for a writ of certiorari) is reported at 588 F.2d 1358. The opinion of the United States District Court for the Southern District of New York (Appendix B to Chiarella's petition for a writ of certiorari) is reported at 450 F.Supp. 95.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit was entered November 29, 1978. A motion for rehearing with a suggestion for rehearing *en banc* was denied by the Court of Appeals on January 4, 1979. The petition for a writ of certiorari was filed on February 2, 1979 and was granted on May 14, 1979. The jurisdiction of this Court rests on 28 U.S.C. §1254(1).

Constitutional Provisions, Statutes and Rules Involved

Constitutional Provisions:

Constitution of the United States, Amendment 5

> No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment of indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

Statutes:

15 U.S.C. §78j(b) (Section 10[b] of the Securities Exchange Act of 1934):

§78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality

of interstate commerce or of the mails, or of any facility of any national securities exchange

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

§15 U.S.C. §78ff(a) (Section 32[a] of the Securities Exchange Act of 1934):

§78ff. Penalties

(a) Any person who willfully violates any provision of this chapter (other than Section 78dd-1 of this title), or any rule or regulation thereunder, the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of Section 78o of this title or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $10,000, or imprisoned not more than five years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed; but no person shall be subject to imprisonment under this Section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

Rule 501, Federal Rules of Evidence:

Except as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience. However, in civil actions and proceedings, with respect to an element of a claim or defense as to which State law supplies the rule of decision, the privilege of a witness, person, government, State, or political subdivision thereof shall be determined in accordance with State law.

New York Labor Law, §537:

§537. Disclosures prohibited

1. Use of information. Information acquired from employers or employees pursuant to this Article shall be for the exclusive use and information of the commissioner in the discharge of his duties hereunder and shall not be open to the public nor be used in any court in any action or proceeding pending therein unless the commissioner is a party to such action or proceeding, notwithstanding any other provisions of law. Such information insofar as it is material to the making and determination of a claim for benefits shall be available to the parties affected and, in the commissioner's discretion, may be made available to the parties affected in connection with effecting placement.

2. Penalties. Any officer or employee of the state, who, without authority of the commissioner or as otherwise required by law, shall disclose such information shall be guilty of a misdemeanor.

Regulations:

17 C.F.R. §240.10b-5 (Rule 10b-5):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Questions Presented for Review

1. Does the purchaser of stock in the open market who fails to disclose material, nonpublic information about the issuer of the stock violate Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 where the purchaser has no fiduciary relationship with the issuer and where the information was obtained from and created by a source wholly outside and unrelated to the issuer?

2. Does the Second Circuit's retroactive application of its new and expansive interpretation of Section 10(b) and Rule 10b-5 to sustain petitioner's conviction violate the Due Process Clause of the Fifth Amendment?

3. In a criminal case charging violations of Section 10(b) and Rule 10b-5, did the trial court violate this Court's holding in *Ernst & Ernst* v. *Hochfelder* by refusing to instruct the jury that "intent to defraud" was a requisite element of the crime?

4. Did the trial court err in admitting into evidence at petitioner's federal criminal trial a confidential statement—in this case tantamount to a confession—required to be made by petitioner to the New York State Department of Labor as a condition of seeking unemployment benefits when New York law makes the statement absolutely privileged from disclosure and makes disclosure of that statement a criminal act?

Statement of the Case

Vincent F. Chiarella was employed as a "mark-up" man in the composing room at Pandick Press, a financial printing company in New York City (R.182-83, 234-35).[1] During the course of his employment in 1975 and 1976, Chiarella worked on setting into type prospectuses and other documents for corporate customers of Pandick who were about to announce take-over bids (tender offers) for other companies (R.283-84). Pandick's customers, the prospective tender offerors, provided the textual material to be printed to Pandick, but particular information as to the identity of the corporation proposed for take-over (the target) was encoded or simply left blank (R.222-23, 228).

1. References in parentheses preceded by "R." are to pages of the original record of the proceedings in the District Court. On June 11, 1979, this Court granted Chiarella's motion to dispense with printing an appendix and for leave to proceed on the original record.

In each case relevant here Chiarella was able to deduce the identity of the takeover candidate (target) from data which was disclosed in the material provided for printing by the prospective offeror corporations (R.474). Then, prior to public announcement of the take-over bids or tender offers, Chiarella purchased shares of the corporation he believed was the target (R.474-78).

Chiarella successfully determined the identity of five companies targeted for take-over by customers of Pandick Press. His 17 separate purchases of target shares, prior to public announcement of the tender offers and sale of those shares after news of the tender offers became public, netted Chiarella a $30,000 profit (GX6, 7, 10, 61).[2]

Since each of Chiarella's stock purchases was transacted through his broker over the open market, Chiarella never met nor had any dealings whatever with the target corporation shareholders whose stock he acquired (R.482). And Chiarella specifically denied that he intended to defraud anyone in connection with his stock purchases (R.483-84).

Prior to Chiarella's stock transactions, Pandick Press had posted a sign (GX14A) warning its employees that it was violative of company policy for any employee to utilize information learned from a customer's copy for his own benefit and that such conduct would result in the employee's termination from employment and could result in criminal penalties. Although Chiarella was aware that his conduct violated Pandick's rules, he did not believe that his actions were unlawful (R.491). Having set the type of hundreds

2. Numerical references in parentheses preceded by "GX" refer to government exhibits in evidence.

of tender offer prospectuses which reveal the details of all pre-announcement trading in target shares by tender offerors, Chiarella was well aware that it was the common practice of prospective tender offerors to purchase target shares on the open market prior to announcement of their tender offer plans (GX31F, R.489-92).[3] Chiarella explained what his knowledge of the practice of offeror corporations meant to him (R.492):

> "I was doing the same thing that they were doing and I had no intention of doing anything wrong with that."

An investigation by the SEC into trading activity in one of the target corporations whose shares Chiarella purchased led to the commencement of an injunctive action by the SEC against Chiarella (*SEC* v. *Chiarella,* No. 77 Civ. 2534 [S.D.N.Y. 1977]). The SEC proceeding was settled when Chiarella entered into a consent decree with the SEC and disgorged his $30,000 profit to those target shareholders whose stock he fortuitously purchased (R. 15-17).

Shortly thereafter Chiarella was fired by Pandick and sought unemployment insurance benefits (R.484-85). In

3. The common practice of a prospective offeror purchasing shares of the prospective target in the open market is demonstrated by one of the proofs Chiarella is alleged to have worked on. Government Exhibit 31F—the printer's proof which underlies Counts 11 and 12—establishes that three weeks prior to the announcement of the tender offer, the offeror had purchased on the open market 34,000 shares of the target corporation's stock. The document contains the following language:

> "Neither the Offeror, any officer or director of the Offeror, nor any affiliated person has effected any transaction in the Shares during the past 60 days *except for the purchase in brokerage transactions by the Offeror during the period from September 7, 1976, through September 17, 1976 of an aggregate of 34,000 shares.* . . ." (Emphasis supplied.)

the process of seeking those benefits, Chiarella met with a New York State unemployment examiner who told Chiarella to explain the reasons for having been fired. Chiarella gave the examiner the full statement of reasons requested (R.275-78).

In January, 1978, Chiarella was indicted on 17 counts (each count representing a separate purchase of target stock) charging violations of Section 10(b) and Rule 10b-5. A pre-trial motion to dismiss the indictment upon the ground that the conduct alleged—the purchase of stock without disclosure of material, nonpublic information—was not within the scope of Section 10(b) and Rule 10b-5 because Chiarella had no relationship with the target corporations and was under no duty to disclose his information which originated with the offeror corporations, was denied in a written opinion (*United States* v. *Chiarella,* 450 F.Supp. 95 [S.D.N.Y. 1978]; Appendix B to Chiarella's petition for a writ of certiorari).

At trial in the Southern District of New York before the Honorable Richard Owen and a jury, Chiarella objected unsuccessfully to the introduction into evidence of the statements he made in connection with seeking unemployment benefits (GX12; transcript of proceedings April 3, 1978, pp. 1-24 — 1-34; transcript of proceedings April 4, 1978, pp. 152-154; R.275). His requests to charge the jury that specific intent to defraud was a requisite element of the crime were denied (R.559-60, 572-73, 712).

On April 10, 1978, Chiarella was convicted on all counts (R.723) and on May 19, 1978 he was sentenced to a term of imprisonment of one year with all but one month suspended on each of counts 1-13 to run concurrently and to

a term of probation of five years on counts 14-17 (see judgment filed May 19, 1978).

Chiarella's conviction was affirmed by the United States Court of Appeals for the Second Circuit on November 29, 1978 by a divided panel (Kaufman, Ch. J. and Smith, J.; Meskill, J. dissenting). A motion for rehearing and suggestion for rehearing *en banc* was denied on January 4, 1979.

Pending this Court's decision, Chiarella's sentence has been stayed. Bail in the form of a $10,000 personal recognizance bond was posted.

Summary of Argument

I. Chiarella's conduct is not within the scope of Section 10(b) and Rule 10b-5. Nothing in the plain language of the statute and rule suggests liability for trading without disclosure of material, nonpublic information. The legislative history of the statute shows that Chiarella's conduct was never intended by congress to be covered by Section 10(b). The administrative history and administrative and judicial interpretations of the Rule show its application to nondisclosure of material nonpublic information has been grounded in the trader's breach of a duty to disclose arising out of a fiduciary or other special relationship with the issuer corporation—a relationship Chiarella concededly did not have. Indeed, conduct identical to Chiarella's—an "outsider's" purchase of an issuer's stock based on and without disclosure of an impending tender offer for the issuer's shares—has specifically been ruled out as a *civil* violation of Rule 10b-5 by every court

that has addressed the issue. Moreover, an expansive interpretation of Section 10(b) and Rule 10b-5 conflicts with the required strict construction of criminal statutes.

II. The fair notice requirement of the Due Process Clause was violated by Chiarella's conviction. The state of the law—prior judicial interpretations, administrative actions and rulings, legislative history, other relevant statutory provisions, as well as custom and usage—was such at the time of his security transactions that no one could have rationally predicted that Chiarella's conduct would come within Section 10(b) and Rule 10b-5. The Second Circuit's novel and expansive interpretation of the law and rule to cover Chiarella's conduct by the creation of a new "test" for liability—"regular access to market information"—is, much like an *ex post facto* law, constitutionally impermissible.

III. The trial court's refusal to charge the jury that "specific intent to defraud" was an essential element of the crimes charged violated this Court's holding in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976). The charge given, that Chiarella could be convicted if the jury found he had a realization that his conduct was wrongful, was not sufficient to charge the very different concept of specific intent to defraud required by *Hochfelder*.

IV. The statements made by Chiarella to New York's Department of Labor and later used against him at his trial should not have been admitted into evidence. The New York law makes the statements absolutely privileged from disclosure, prohibits their use in any court, and punishes disclosure as a criminal offense. This privilege and

rule of inadmissibility should have been sustained in Chiarella's federal criminal trial under Rule 501 of the Federal Rules of Evidence. Honoring the privilege in federal court is consistent with federal interests. Congressional enactments have evinced a clear intent to protect information required by federal as well as state agencies. Constitutional considerations, founded on the Fifth Amendment right against self-incrimination, also favor recognition of the privileged status of this information. In addition, this Court has approved a specific rule which would have required federal courts to defer to the state privilege which attached to Chiarella's statement.

ARGUMENT

POINT I

The purchase of stock on the open market based on and without disclosure of material, nonpublic information does not violate Section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5 promulgated thereunder where the purchaser has no fiduciary or other special relationship with the issuer or its stockholders and the information was obtained from and created by a source wholly outside and unrelated to the issuer.

A. Introduction

This case is the first criminal prosecution ever brought under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 for securities trading based on and without disclosure of material, nonpublic information. Not even a true corporate "insider" (which Chiarella is not) who traded on "inside" information obtained from

the issuer corporation (which Chiarella did not) has ever been charged with a crime under Section 10(b) and Rule 10b-5. Nor has there ever been a litigation in which even civil liability for nondisclosure has been imposed under Section 10(b) and Rule 10b-5 on someone like Chiarella who concededly is not an "insider," the "tippee" of an "insider," or one with a special relationship with other traders and investors.

Nothing in the language or history of Section 10(b) and Rule 10b-5 supports the expansion of the statute and rule to embrace the conduct at issue here. Indeed, conduct identical to Chiarella's—an "outsider's" purchase of an issuer's stock based on and without disclosure of an impending tender offer for the issuer's shares—has specifically been ruled out as a civil breach of Section 10(b) and Rule 10b-5 by every court that has addressed the issue. Moreover, the expansive view of the statute and rule urged by the government in support of this criminal case and adopted by the courts below to uphold the indictment and affirm the conviction flatly conflicts with the fundamental rule requiring strict construction of penal laws.

B. The Language and History of Section 10(b) and Rule 10b-5

Mr. Justice Rehnquist noted in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737 (1975), that the case law which has developed under Section 10(b) of the 1934 Securities Exchange Act is tantamount to "a judicial oak which has grown from little more than a legislative acorn." The metaphor is particularly apt in this case because analysis of the language and history of the statute and Rule

10b-5 promulgated by the SEC pursuant to the statute shows that the genetic makeup of the "acorn" is inconsistent with what the government urges should be a new branch on the "judicial oak"—criminal liability for mere silence by a non-insider in connection with a stock transaction.

1. The Language of the Statute and Rule

The language of Section 10(b) and Rule 10b-5 does not proscribe trading without disclosure of material, nonpublic information. Section 10(b) makes unlawful "in connection with the purchase or sale" of securities the "use or employ[ment]" of "any manipulative or deceptive device or contrivance" in contravention of SEC rules. SEC's Rule 10b-5 prohibits in connection with the purchase or sale of securities (1) the "employ[ment of] any device, scheme, or artifice to defraud," (2) the "mak[ing of] any untrue statement of a material fact" or the "omi[ssion] to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading," and (3) the "engag[ing] in any act, practice or course of business which operates or would operate as a fraud or deceit."

The only nondisclosure specifically addressed is the failure to reveal "a material fact" necessary to make other statements made not misleading. Thus, affirmative misrepresentation by the device of half-truths is plainly prohibited by the language of Rule 10b-5. Total silence in connection with a stock transaction—the conduct at issue here—is not referred to at all.[4] Indeed, since the "scope [of SEC Rule 10b-5] cannot exceed the power granted the Commission by Congress under §10(b)" which proscribes only "manipulative or deceptive device[s] or contrivance[s]," the general fraud prohibitions of clauses 1 and 3 of Rule 10b-5 (employing a "device, scheme, or artifice to defraud" and engaging in an "act, practice or course of business which operates . . . as a fraud or deceit") cannot be construed to make unlawful *every* failure to disclose material, nonpublic information (*Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 [1976]). At most, only a failure to disclose that amounts to a "manipulative or deceptive device or contrivance" is within the plain meaning of Section 10(b) and Rule 10b-5.

2. Legislative History of Section 10(b)

Nothing in the legislative history of Section 10(b) reveals a congressional intent to include trading without disclosure of material, nonpublic information within the concept of "manipulative or deceptive device or contrivance." Congressional concern was with prohibiting manipulative and deceptive devices in connection with stock transactions which had the danger of artificially and dishonestly affecting the market price of securities. The language now comprising Section 10(b) was originally included as Section 9(c) of the bills introduced in the Senate and House (S. 2693, 73d Cong. 2d Sess. [1934]; H.R.

4. In recognition of the plain meaning of clause 2 of Rule 10b-5, the district court dismissed that portion of the indictment charging Chiarella with having omitted to state a material fact necessary in order to make the statements made not misleading (R.537, 550). Since Chiarella made no statement at all in connection with his stock purchases, there was no evidence to support the charge that he violated clause 2 of Rule 10b-5.

7852, 73d Cong. 2d Sess. [1934]; H.R. 8720, 73d Cong. 2d Sess. [1934]). The other subsections of Section 9 authorized the SEC to regulate securities transactions involving "short" sales and "stop-loss" orders—practices which could create a false or misleading appearance of trading activity and have an effect on market prices not reflective of true market conditions. The committee hearings regarding Section 9(c)'s prohibition on the use of "any manipulative or deceptive device or contrivance" reveal that the subsection was designed as a catch-all to insure that other types of manipulation or deception resulting in the generation of artificial prices not specifically prohibited by the express provisions of Section 9 would be prohibited through appropriate SEC regulation. *See* Hearings on Stock Exchange Regulations Before the House Committee on Interstate and Foreign Commerce, 73d Cong. 2d Sess. 115 (1934).[5] Trading on material, nonpublic information, a practice which would tend to push the market price of a security in the right direction, is not within the ambit of congress' intention to regulate "manipulative or deceptive device[s] or contrivance[s]" which could

5. There is evidence in the legislative history that congress assumed that problems regarding trading without disclosure of material, nonpublic information were distinct from problems of manipulation and deception. Congress chose to deal with the problem of "insider" trading explicitly in Section 16(b) (15 U.S.C. §78p[b]) by providing for corporate recovery of short swing profits made on transactions by "insiders." There is no suggestion anywhere in the legislative history of the 1934 Act that congress intended any other section to deal with the subject. *See*, S. Rep. No. 792, 73rd Cong. 2d Sess. 9, 12-15, 21 (1934); Remarks of Congressman Lea, 78 Cong. Rec. 7861-62 (1934); S. Rep. No. 1455, 73d Cong. 2d Sess. (1934); H.R. Rep. No. 1383, 73d Cong. 2d Sess. (1934); Hearings on Stock Exchange Regulation Before the House Committee on Interstate and Foreign Commerce, 73d Cong. 2d Sess. 132-35 (1934). *See also,* Manne, *Insider Trading and the Administrative Process,* 35 Geo. Wash. L. Rev. 473, 491-92 (1967); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?,* 57 Nw. U.L. Rev. 627, 652-54 (1962).

artificially affect market prices and not reflect true market conditions. *See* H. G. Manne, Insider Trading in the Stock Market (1966).

3. *Administrative History and Interpretation of the Rule*

In contrast to the legislative history of Section 10(b) which does not specifically address the issue of trading without disclosure of material, nonpublic information, the administrative history and interpretation of Rule 10b-5 is enlightening. The Rule was adopted by the SEC in 1942 to close ". . . a loophole in the protections against fraud administered by the [SEC] by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Release No. 3220 (May 21, 1942).[6] No definition of "fraud" was supplied by the SEC at the time of the Rule's adoption. The burden of later SEC interpretations of its Rule makes clear that a failure to disclose material, nonpublic information in connection with a stock transaction amounts to "fraud" within the scope of Rule 10b-5 only where the failure to disclose is in breach of an affirmative duty to disclose. *In the Matter of Cady, Roberts & Co.,* 40 S.E.C. 907 (1961); *but*

6. The Rule appears to have been adopted over the course of one or two days when the SEC realized that the antifraud provisions of the 1933 Securities Act (15 U.S.C. §77q[a]) applied only to the "offer or sale" of securities and not their purchase. The Rule was adopted in particular response to a Regional Administrator's report regarding a corporate president who, while misrepresenting to other shareholders that the corporation was doing very badly, was buying up their shares and failing to disclose that the corporate earnings were going to quadruple. When the text of Rule 10b-5 drafted in response to the report was presented to the commissioners, all approved it and the only comment made was "Well . . . we are against fraud, aren't we?" *See* Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967) (remarks of Milton Freedman, one of the Rule's co-drafters).

compare, e.g., SEC v. *Sorg Printing Co., Inc.*, CCH Fed. Sec. L. Rep. ¶95,034 (S.D.N.Y. 1975).

Cady, Roberts & Co., supra, is the seminal SEC interpretation applying Rule 10b-5 to the nondisclosure of material, nonpublic information in connection with securities trading. The SEC ruled that Section 10(b) and Rule 10b-5 had been violated by Cady, Roberts & Co., a stock brokerage partnership and one of its partners who sold stock of Curtiss-Wright Corp., on the basis and without disclosure of highly unfavorable and unpublished dividend information obtained from a Curtiss-Wright director who was also a registered representative employed by Cady, Roberts.[7] Because the case was "of first impression and one of signal importance in [the SEC's] administration of the Federal securities acts" (*Cady, Roberts, supra,* at 907), Chairman William L. Cary painstakingly spelled out the legal principles underlying the SEC's application of Rule 10b-5 (*id.* at 911-12):

> ". . . Rule 10b-5 appl[ies] to securities transactions by 'any person.' Misrepresentations will lie within [its] ambit, no matter who the speaker may be. *An affirmative duty to disclose material information has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders. We and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the antifraud provisions.*

7. The SEC proceedings in *Cady, Roberts & Co.* were resolved by Cady, Roberts & Co.'s offer of settlement permitting a maximum sanction of a 20-day suspension of the trading partner from membership on the New York Stock Exchange. Apparently there was no referral of the matter by the SEC to the Justice Department's Criminal Division.

> * * *
>
> "Thus our task here is to identify *those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading its securities.* Intimacy demands restraint lest the uninformed be exploited." (Emphasis supplied.)

The SEC thus made it plain nearly twenty years after Rule 10b-5 was promulgated that, unlike a misrepresentation in connection with a securities transaction which is a fraud under Rule 10b-5 "no matter who the speaker may be," total nondisclosure amounts to a Rule 10b-5 fraud only when the silence is in breach of "an affirmative duty to disclose" such as the duty of one who "[is] in a special relationship with a company, . . . privy to its internal affairs . . . and trad[es] its securities."[8] This well-rea-

8. The SEC's citation in *Cady, Roberts* to *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D.Del. 1951) and *Kardon* v. *National Gypsum Co.*, 73 F. Supp. 798, 800 (E.D. Pa. 1947) as the sole judicial support for its interpretation of Rule 10b-5 makes powerfully clear that the application of Rule 10b-5 to nondisclosure in connection with a securities transaction was meant to embrace only a nondisclosure which violates an insider's duty to disclose. In *Speed* v. *Transamerica, supra,* 99 F. Supp. at 828-29, Chief Judge Leahy wrote:

> "The rule [*i.e.*, Rule 10b-5] is clear. It is unlawful for an insider, such as a majority shareholder, to purchase the stock of minority shareholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his

(footnote continued on next page)

soned interpretation of the Rule cannot be said to have been modified in any sense by the mere commencement by the SEC of injunctive actions against Chiarella and other printers, especially where none of those actions were accompanied by interpretative opinions or policy pronouncements varying from *Cady, Roberts*. *E.g., SEC* v. *Sorg Printing Co., Inc., supra*.

C. Judicial Development of Section 10(b) and Rule 10b-5

The case law regarding nondisclosure liability under Rule 10b-5 after *Cady, Roberts* and before *Chiarella* is undeviating. Liability under the section and rule for the failure to disclose material information concerning the stock of an issuer has been found *only* where the failure to disclose is in breach of an affirmative duty to disclose arising out of a fiduciary relationship the trader or the original source of the information has with the issuer or out of some other special relationship the trader has with the issuer or other investors. Absent an affirmative duty to disclose, the cases make it perfectly clear that trading on the basis of material, nonpublic information is not a violation of Section 10(b) and Rule 10b-5.

The landmark case of *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied*, 394

position to take unfair advantage of the uninformed minority stockholders."

And in *Kardon* v. *National Gypsum Co., supra*, 73 F. Supp. at 800, the court wrote:

> "Under any reasonably liberal construction, these provisions [of Rule 10b-5] apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction."

U.S. 976 (1969), is illustrative. In that case the SEC sought to enjoin Texas Gulf Sulphur and several of its officers, directors and employees from violating Section 10(b) and Rule 10b-5 and to compel the rescission of securities transactions in the stock of Texas Gulf Sulphur entered into by the individual defendants on the basis and without disclosure of material, nonpublic inside information. The Second Circuit ruled that the nondisclosure violated Section 10(b) and Rule 10b-5 because the insiders had an affirmative duty to disclose inside corporate information when trading in the shares of the corporation. Relying on the SEC's decision in *Cady, Roberts, supra*, the court wrote (401 F.2d at 848):

> ". . . anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing . . . or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed."

In finding an affirmative duty to disclose in *Texas Gulf Sulphur*, the court relied on "traditional fiduciary concepts" and the "'special facts' doctrine" developed in common law tort cases involving fraud by silence (401 F.2d at 848). The essence of the common law rule is that a tort action for fraud by silence lies where one party to a business transaction fails to disclose facts material to the transaction that the other party is entitled to know because of a fiduciary or other special relation of trust and confidence between them. *See, e.g., Strong* v. *Repide*, 213 U.S. 419 (1909); *Hotchkiss* v. *Fisher*, 136 Kan. 530, 16 P.2d 531 (1932); *Oliver* v. *Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); *Diamond* v. *Oreamuno*, 24 N.Y. 2d 494, 248 N.E. 2d

910 (1969); 3 L. Loss, Securities Regulation 1446-48 (2d ed. 1961); 3 Fletcher, Cyclopedia Corporations 281-92 (1975 revision); ALI Restatement of the Law 2d, Torts §551(2)(a).[9]

As Chief Judge Fuld wrote in *Diamond* v. *Oreamuno*, *supra*, 24 N.Y. 2d at 498-99, a securities fraud by silence case:

> "Just as a trustee has no right to retain for himself the profits yielded by property placed in his possession but must account to his beneficiaries, a corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use. . . . [T]here can be no justification for permitting officers and directors . . . to retain . . . profits which . . . they derived solely from exploiting information gained by virtue of their inside position as corporate officials."

Since *Texas Gulf Sulphur*, it has become firmly entrenched in Section 10(b) and Rule 10b-5 case law that nondisclosure amounts to a "manipulative or deceptive device or contrivance" *only* when such nondisclosure is in breach of a duty to disclose arising out of a fiduciary relationship between the trader or the original source of information and the issuer or some special trustee type of relationship between the trader and other investors.[10] *See*,

9. As the treatises point out, it was the so-called "minority rule" of the common law which imposed a fiduciary obligation to disclose upon insiders when trading the shares of their corporation. 3 Fletcher, Cyclopedia Corporations, *supra*, 288-92; 3 L. Loss, Securities Regulation, *supra*, at 1446-47.

10. In opposing certiorari, in *SEC* v. *Texas Gulf Sulphur*, *supra*, the SEC itself acknowledged that the duty to disclose arises out of the fiduciary obligation a corporate "insider" owes the corporation's shareholders. (*See* Brief for the SEC in opposition to petition for a writ of certiorari in *Coates* v. *SEC*, No. 68-897, p.17.)

e.g., *Lewelling* v. *First California Co.*, 564 F.2d 1277 (9th Cir. 1977); *Schein* v. *Chasen*, 478 F.2d 817, 823 (2d Cir. 1973), *vacated on other grounds*, 416 U.S. 386 (1974); *Radiation Dynamics, Inc.* v. *Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972); *SEC* v. *Great American Industries, Inc.*, 407 F.2d 453, 460 (2d Cir. 1968) (*en banc*), *cert. denied*, 395 U.S. 920 (1969); *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Kohler* v. *Kohler Co.*, 319 F.2d 634 (7th Cir. 1963). The Second Circuit wrote in 1972:

> "The essential purpose of Rule 10b-5, as we have stated time and again, is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders." *Radiation Dynamics, Inc.* v. *Goldmuntz*, *supra*, 464 F.2d at 890.

Absent such a relationship and the correlative duty to disclose, nondisclosure of material, nonpublic information is not a Rule 10b-5 violation.

> "The party charged with failing to disclose market information must be under a duty to disclose it to the plaintiffs." *Frigitemp Corp.* v. *Financial Dynamics Fund, Inc.*, 524 F.2d 275, 282 (2d Cir. 1975).

This state of the law was spelled out by the American Law Institute in its 1978 Proposed Official Draft of the Federal Securities Code.[11] In codifying the existing law regarding trading based on and without disclosure of ma-

11. The American Law Institute's Proposed Official Draft of the Federal Securities Code (1978) was the result of an intensive effort over more than eight years to codify the federal securities laws by synthesizing the myriad statutes, administrative rules and court decisions spawned since 1933.

terial, nonpublic information, the ALI made it plain that some cases of nondisclosure of material information do not involve "fraud" and hence do not come within the scope of Section 10(b). Under the proposed code such nondisclosure is "unlawful" in connection with a security transaction when an "insider" trades in the shares of his own corporation and "may be" "unlawful" when "any person" fails to disclose in breach of "a duty to act or speak." *See* ALI Proposed Official Draft of the Federal Securities Code (1978), §§1602, 1603, 262(b).[12]

Under the ALI codification or any judicial interpretation of the embrace of Section 10(b) and Rule 10b-5 prior to the Second Circuit's opinion in this case, Chiarella's nondisclosure was in breach of no duty to disclose. He was clearly not an "insider" or a "tippee" of an "insider" of the target corporations whose shares he purchased.

12. In relevant part, the ALI proposed code provides as follows:

"Sec. 1603. (a) It is unlawful for an insider to sell or buy a security of the issuer, if he knows a fact of special significance with respect to the issuer or the security that is not generally available. . . . (b) 'Insider' means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person whose relationship or former relationship to the issuer gives or gave him access to a fact of special significance about the issuer or the security that is not generally available, or (4) a person who learns such a fact from a person specified in Section 1603(b) . . . with knowledge that the person from whom he learns the fact is such a person. . . ."

"Sec. 1602. (a) It is unlawful for any person to engage in a fraudulent act . . . in connection with (1) a sale or purchase of a security . . . ."

"Sec. 262. (b) Inaction or silence when there is a duty to act or speak may be a fraudulent act."

Chiarella had no relationship whatever with those corporations. Chiarella acquired information about the "target" corporations, *i.e.*, that they were about to become the subject of tender offers, from the offerors who were themselves "outsiders," and, as we demonstrate below, free to use the information to purchase the stock about to become targeted without fear of 10b-5 liability.

The precise same analysis has been used by several courts which have squarely held that conduct identical to Chiarella's—an outsider's open market purchase of an issuer's stock based on and without disclosure of information regarding an impending tender offer for the issuer's stock where the information was not derived through any relationship with the issuer—does not amount to a Rule 10b-5 violation.

In *General Time Corp.* v. *Talley Industries, Inc.*, 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969), Talley Industries acquired shares of General Time Corp. on the open market without disclosing its plan for a merger "whose terms might be more favorable than the price paid for the stock being acquired" (*id.* at 164). The Second Circuit, two months after its decision in *Texas Gulf Sulphur*, held that there was no violation of Rule 10b-5 because in purchasing the General Time shares Talley was not utilizing information of and had no fiduciary relation with General Time. Judge Friendly wrote as follows (*id.*):

> "We know of no rule of law, applicable at the time, that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller,

had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale . . . ."[13]

Similarly, in *Mills* v. *Sarjem Corp.*, 133 F. Supp. 753 (D.N.J. 1955), the court found no Rule 10b-5 violation in the conduct of an outside syndicate which purchased all the stock of a bridge company for the purpose of reselling the gathered stock at a profit without divulging in a solicitation letter sent to stockholders its plans to resell. The court wrote (*id.* at 764-65):

"The cases imposing a duty on the part of a purchaser of shares to disclose his knowledge of future prospects and plans all involve situations where the purchaser

13. Judge Friendly's allusion to a change in the applicable law refers to enactment of the Williams Act. The purpose of that legislation was to remedy a gap in the securities laws by subjecting tender offerors and, in certain circumstances, prospective tender offerors, to disclosure requirements. Under 15 U.S.C. §78m(d)(1) takeover bidders must file with the SEC a statement disclosing, *inter alia*, the "background and identity" of the offeror, the source and amount of funds to be used in the purchase, the extent of the offeror's holdings in the target corporations, and the offeror's plans regarding the target. Additionally, the Williams Act provides protection for shareholders who elect to tender their stock (15 U.S.C. §78n[d][5], [6]), and prohibits fraud in connection with any tender offer (15 U.S.C. §78n[e]).

It is only after 5% of the target company's stock is acquired by the offeror, however, that plans regarding the target need be disclosed (15 U.S.C. §78m[d][1]). The changes in law made by the Williams Act did not otherwise affect the legality of a prospective offeror purchasing shares of a target on the open market without disclosing the impending offer. *See Gulf & Western Industries, Inc.* v. *Great Atlantic & Pacific Tea Co.*, 356 F. Supp. 1066 (S.D.N.Y.), *aff'd on other grounds*, 476 F.2d 687 (2d Cir. 1973); *Copperweld Corp.* v. *Imetal*, 403 F. Supp. 579 (W.D. Pa. 1975). Whatever policy considerations congress reflected in permitting prospective offerors to trade target stock until it acquires 5% of the target stock and thereby becomes an "insider" of the target applies with equal force to Chiarella. None of his purchases came anywhere near the 5% limit, and thus he was not and could not have been charged with a violation of the Williams Act.

holds a fiduciary position and where the knowledge has been obtained by virtue of an 'insider' position."

And *see, Pacific Insurance Co. of New York* v. *Blot*,[14] 267 F. Supp. 956, 957 n.2 (S.D.N.Y. 1967) ("The Court entertains grave doubt whether the alleged failure by the defendant, an 'outsider,' to disclose to selling shareholders the impending tender offer . . . constitutes a violation of Rule 10b-5."); *Mutual Shares Corp.* v. *Genesco, Inc.*, 384 F.2d 540, 545 (2d Cir. 1967); *Jacobsen Manufacturing Co.* v. *Sterling Precision Corp.*, 282 F. Supp. 598, 603 (E.D. Wis. 1968).

The scholars, too, teach that Rule 10b-5 is not violated by the common practice of a prospective offeror making open market purchases of shares of the target without dis-

14. In *Blot* the SEC filed an *amicus* brief setting forth its view that the purchase of an issuer's stock based on and without disclosure of nonpublic information regarding an upcoming tender offer for the stock did not violate Section 10(b) and Rule 10b-5. The SEC wrote:

". . . we . . . believe that defendant had no affirmative duty to come forward and disclose that forthcoming tender offer when purchasing shares . . . . .

". . . in order to create an affirmative duty to disclose material facts before purchasing securities . . . there must . . . be some relationship giving rise to a duty to disclose. . . .

"We believe that there is no duty to make public . . . the fact that an individual is purchasing or seeking to purchase a corporation's stock. The mere fact that such information might be of interest to prospective investors, stockholders and the corporation is insufficient to place a duty on a purchaser, and does not approach a violation of Rule 10b-5.

". . . We are inclined to believe that . . . defendant's failure to disclose his contemplated tender offer at a higher price . . . [did not] constitute a violation."

(Memorandum of the SEC submitted *amicus curiae* in *Pacific Ins. Co.* v. *Blot*, 67 Civ. 1386 [S.D.N.Y.], pp. 5-7).

closing an impending tender offer. Professor Bromberg states:

> "The prospective offeror often buys some of the target company's securities in the open market . . . before the offer is announced. *The antifraud rules are apparently not violated. . . . Although the offeror is using material nonpublic information, it is information created by itself rather than emanating from the target company. Thus it is probably not inside information about the latter company's securities. . . . In any event, if it is not obtained by 'access' to the target company, the possessor is not . . . an insider subject to trading prohibitions.*" (A. Bromberg, Securities Law: Fraud §6.3 [1969]) (Emphasis supplied.)

And in a recent treatise on tender offers, the authors wrote:

> "When a prospective tender offeror engages in market purchases of the target company's stock, presumably it is not acting upon information acquired as an insider of the target . . . . *Therefore, information concerning the planned tender offer need not be disclosed by the offeror before it makes market purchases of the target's securities.*" E. R. Aranow, H. A. Einhorn, and G. Berlstein, Developments in Tender Offers for Corporate Control, 20 (1977). (Emphasis supplied.)

See also Fleischer and Mundheim, *Corporate Acquisition by Tender Offer*, 115 Penn. L. Rev. 317, 338 (1967).

There is no meaningful distinction between Chiarella's conduct and a prospective tender offeror's open market purchase of an issuer's stock without disclosure of its own planned tender offer; analytically the conduct is the same. In each case target shares are sold by a shareholder who is

unaware that the shares are about to become the object of a takeover bid. That in one case the nondisclosing purchaser is the prospective tender offeror and in the other it is Chiarella—a "tippee" of the prospective offeror—is surely of no consequence to the selling shareholder. Since neither the prospective offeror nor Chiarella, its tippee, has any fiduciary or other relationship with the issuer or its shareholders giving rise to an affirmative duty to disclose information, neither has an "obligation to reveal circumstances that might raise a seller's demands and thus abort the sale." *General Time Corp.* v. *Talley Industries, Inc.*, *supra*, 403 F.2d at 164.

In affirming Chiarella's conviction, the Second Circuit panel majority avoided the impact of the *General Time* line of authority by reasoning that ". . . the offerors and Chiarella occupy entirely different positions with respect to trading on news of an impending tender offer" (588 F.2d at 1366). To the panel majority the difference between a prospective tender offeror's proper conduct under Rule 10b-5 and Chiarella's Rule 10b-5 felonies is that purchases of target shares by the offeror is accompanied by "substantial economic risk" whereas Chiarella has "no economic risk whatsoever" (588 F.2d at 1366-67). There is simply no authority in the language, history or judicial interpretations of Section 10(b) and Rule 10b-5 for the proposition that the degree of risk assumed by a trader is at all relevant to distinguish between legitimate and felonious conduct under the Statute and Rule.

The Second Circuit panel majority also sought to distinguish the *General Time* line of authority by the fact that Chiarella's use of the information violated a fiduciary duty he owed his employer and its customers—the offerors,

whereas when the offerors purchase target shares they merely use information they themselves create (588 F.2d at 1367-68). This distinction too is legally impotent. This Court has very specifically held that Rule 10b-5 violations are not made out by "all breaches of fiduciary duty in connection with a securities transaction." *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 472 (1977).[15] Moreover, Chiarella was not charged with having breached any fiduciary duty he may have owed his employer or its customers.

The Second Circuit's tortured distinctions amply demonstrate that there is simply no way to read Section 10(b) and the judicial development of it to glean that Chiarella's trading is prohibited, but not that of the prospective tender offeror. The distinction fashioned and relied upon by the Second Circuit to affirm—that Chiarella is a "market insider" who has "regular access to market information"—is a classic bootstrap analysis. The "test" of "regular access to market information," found nowhere in prior law, could not have been known by Chiarella or anyone else until it was read in the Second Circuit opinion.

15. In denying Chiarella's motion to dismiss the indictment for failure to state an offense, the district court distinguished the *General Time* line of authority from Chiarella's conduct by reasoning that " . . . corporate purchases [by prospective offerors of target shares] have a presumptively legitimate business purpose to promote economic growth and are appropriately made without disclosure" whereas Chiarella's use of the same information obtained from the offerors "was solely for personal profit . . ." (450 F. Supp. 95, 97). The Second Circuit specifically disavowed "relying on any concept of 'business purpose' in distinguishing Chiarella from [the offerors]" and, citing *Santa Fe Industries, Inc.* v. *Green, supra*, agreed with Chiarella that " 'business purpose' cannot be dispositive of liability under Rule 10b-5" (588 F.2d at 1368 n.15).

Of course any distinction between criminal and non-criminal conduct based on the status of a defendant defies the most rudimentary concepts embodied in due process and equal protection law.

The judicial development of the scope of Section 10(b) and Rule 10b-5 leaves no question that Chiarella's conduct is outside their scope. As Judge Meskill said in his dissent from the Second Circuit's majority opinion affirming Chiarella's conviction (588 F.2d at 1373):

> "Today's decision expands §10(b) drastically, it does so without clear indication in prior law that this is the next step on the path of judicial development of §10(b) and, alarmingly, it does so in the context of a criminal case.
>
> * * *
>
> "That today's application of §10(b) is a departure from prior law cannot be disputed (footnote omitted)."

D. The Second Circuit's New and Expansive Interpretation of Section 10(b) and Rule 10b-5

The Second Circuit panel majority rejected the well-recognized authorities reviewed above as "irrelevant" (588 F.2d at 1364), failed to heed this Court's many recent warnings in civil cases that Section 10(b) is not to be interpreted expansively (*International Brotherhood of Teamsters* v. *Daniel*, —— U.S. ——, 99 S. Ct. 790 [1979]; *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 [1977]; *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 [1976]) and, in the context of this criminal case, created a new concept of "market insider" (588 F.2d at 1364-65) and relied on that concept to affirm Chiarella's conviction. The new rule for nondisclosure liability under Section 10(b) and Rule 10b-5 announced by Chief Judge Kaufman for the majority is as follows (588 F.2d at 1365):

> "*Anyone*—corporate insider or not—who regularly receives material nonpublic information may not use

that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose [footnote omitted] he must abstain from buying or selling.'"[16]

As its sole support for its novel holding of Rule 10b-5 nondisclosure liability through a "test of 'regular access' to market information" (588 F.2d at 1365-66), the Second Circuit panel majority relied on this Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972). Reliance on that case is misplaced. In *Affiliated Ute* a bank and two of its employees acted as transfer agent for shares of the Ute Development Corporation (UDC), an entity created by the government to hold assets of a group of mixed-blood Ute Indians. There were two separate markets for the shares of UDC—a primary market consisting of Indians selling to whites (including the two bank employees) through the bank as transfer agent and a resale market consisting of whites selling to whites at substantially higher prices. The bank and its two employees became market makers who were active in encouraging a resale market for the UDC shareholders' stock. They devised a plan and induced holders of stock to dispose of their shares without disclosing the resale market of which they were aware and which, in fact, they had created. This Court ruled that the special relationship between the

16. The language parallel between the "market insider" rule announced by the Second Circuit panel majority in this case and the "corporate insider" rule in *Texas Gulf Sulphur* strikingly demonstrates the new rule's departure from settled law. As quoted above, the Second Circuit (*en banc*) in *SEC* v. *Texas Gulf Sulphur* wrote:

> ". . . anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . . or chooses not to do so, must abstain from trading or recommending the securities concerned." (401 F.2d at 848).

bank and its employees as transfer agent and the selling UDC shareholders imposed an affirmative duty on the employees to disclose. The nondisclosure of the conditions of the resale market was held to be in contravention of Section 10(b) and Rule 10b-5.

But the concept underpinning the Second Circuit majority opinion—regular access to market information—was flatly rejected by this Court as a basis for finding an affirmative duty to disclose and Section 10(b) and Rule 10b-5 liability. Mere access by the bank and its employees to market information regarding the resale market by virtue of their role as transfer agent was rejected outright as giving rise to a disclosure duty. Mr. Justice Blackmun wrote as follows (*id.* at 152):

> ". . . if the two men and the employer bank had functioned merely as a transfer agent, there would have been no duty of disclosure here."

Rather, the duty to disclose found in *Affiliated Ute* arose from the relationship the bank and its employees had with the selling shareholders:

> "*The . . . defendants, in a distinct sense, were market makers,* not only for their personal purchases . . . , but for the other sales their activities produced. *This being so they possessed the affirmative duty under the Rule to disclose. . . .*" (Emphasis supplied.) (*Id.* at 153.)

Thus, it was not regular access to market information but the defendants' role as market maker and agent for the selling shareholder that gave rise to a duty to disclose. Very much unlike the defendants in *Affiliated Ute* Chiarella

had no relationship at all with the selling shareholders of the target corporations—he did not undertake to act for them nor did he enter the type of special relationship with them which was determinative in *Affiliated Ute*.[17]

Moreover, the Second Circuit's replacement of the traditional "corporate insider" test with its new "market insider" test portends a licentious extension of Rule 10b-5 liability to regular and accepted trading activities by security industry employees. Thus, trading without disclosure by specialists, block positioners, floor traders, arbitrageurs and risk arbitrageurs—all of whom have "regular access to market information"—would be subject to Rule 10b-5 liability. Yet the market activities of these "market insiders" has been recognized by the SEC as "necessary" in order to "increase the depth, liquidity and orderliness of trading markets." Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 Fed. Reg. 3902, 3918 (Feb. 8, 1973); *see also*, SEC Report of the Special Study of the Options Market, H.R. Comm. Print No. 96-IFC3, 96th Cong. 1st Sess. 1-4 (1978).

The SEC itself has taken the position that unlike use of nonpublic "inside" information, use of nonpublic "market" information should not be regulated under Rule 10b-5. Ten years after *Cady, Roberts*, in transmitting its *Institutional Investor Study Report* to Congress the SEC recommended *against* the use of Rule 10b-5 to regulate the common market practice of "warehousing"—a process by which a would-be tender offeror alerts "friendly" institutional investors of an impending tender offer in order to encourage the transfer of the target company's stock to investors who are likely to be receptive to the tender offer when announced. In its report the SEC expressly noted that "different underlying principles" from those involved in the misuse of "inside" information should govern the use of "market" information. 8 SEC Institutional Investor Study Report, H.R. Doc. No. 92-64, 92d Cong. 1st Sess. xxii, xxxii (1971). The Commission stated that the "different underlying principles" does:

> "not necessarily mean that such passing on of information concerning takeovers should be permitted, but it may well mean that if such activities are to be prohibited, this should be done by a rule specifically directed to that situation rather than by an expanded interpretation of Rule 10b-5 resting on a somewhat different theory than that underlying that rule as to the obligations and duties of those who receive material undisclosed [corporate] information." (*Id.*)

The SEC's position that the use of nonpublic "market" information should not be regulated by "an expanded interpretation of Rule 10b-5" was reiterated in 1973 (Securities Exchange Act Release No. 10316 [Aug. 1, 1973], 2 SEC Docket 229 [Aug. 14, 1973]) and again this year when the SEC proposed the adoption under Section 14(e) of the 1934 Securities Exchange Act (the Williams Act) of Rule 14e-2—a specific rule aimed at regulation of the trading activities of would-be tender offerors and their tippees once a decision to make a tender offer has been formulated.

17. Thus, Chief Judge Kaufman was in error when, relying on *Affiliated Ute*, he wrote that "a duty to disclose arising out of regular access to market information is not a stranger to the world of 10b-5" (588 F.2d at 1366). It was the duty to disclose arising out of the "special relationship" the defendants in *Affiliated Ute* had with selling shareholders which is "not a stranger" to the world of the federal securities laws. *See SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 1963); *Zweig* v. *Hearst Corp.*, —— F.2d ——, CCH Fed. Sec. L. Rep. ¶96,851 (9th Cir. 1979).

Securities Exchange Act Release No. 6022 (Feb. 5, 1979), 44 Fed. Reg. 9956 (Feb. 15, 1979). Notably *not* proposed under Section 10(b) of the 1934 Act, the new proposed rule powerfully evidences what appears to be the SEC's own view that pre-tender trading without disclosure in target stock by "outsiders" *vis-a-vis* the target is not within the scope of Rule 10b-5.[18]

Perhaps recognizing, as did the SEC, that embracing the use of nonpublic market information within Rule 10b-5 departs from all prior law, the Second Circuit majority found some justification for its new and expansive rule in the policy consideration that remedial legislation, such as the 1934 Securities Exchange Act should be broadly construed to effectuate its purpose, namely to provide to all securities traders "equal access to material information" (588 F.2d at 1365). The answer is three-pronged. First, "equal access to material information" does not mean and never has meant that there must be parity of information between traders. As Chief Judge Kaufman himself noted for the panel majority:

> "We are not to be understood as holding that no one may trade on nonpublic market information without incurring a duty to disclose." (588 F.2d at 1366).

That the "equal access" test is not a controlling principle is amply demonstrated by cases like *General Time Corp.* v. *Talley Industries Inc., supra.*

18. This view by the SEC is obviously inconsistent with positions it has taken in a few enforcement actions against printers including Chiarella. *See, e.g., SEC* v. *Sorg Printing Co., Inc.,* CCH Fed. Sec. L. Rep. ¶95,034 (S.D.N.Y. 1975); *SEC* v. *Primar Typographers, Inc.,* CCH Fed. Sec. L. Rep. ¶95,734 (S.D.N.Y. 1976); *SEC* v. *Ayoub,* CCH Fed. Sec. L. Rep. ¶95,567 (S.D.N.Y. 1976); *SEC* v. *Chiarella,* No. 77 Civ. 2534 (S.D.N.Y. 1977). Each of these actions resulted in civil consent decrees with no litigation as to the viability of the Rule 10b-5 claim.

Second, and more importantly in the context of this *criminal* case, the policy of broad construction of remedial legislation runs directly afoul of the fundamental tenet of our criminal jurisprudence that criminal statutes must be strictly construed in favor of an accused. *See United States* v. *Dunn,* —— U.S. ——, 47 U.S.L.W. 4607, 4611 (June 4, 1979) and cases cited therein. Where, as here, conduct identical to Chiarella's has specifically been held to amount not even to a civil breach of Rule 10b-5 it is *a fortiori* that such conduct cannot be subject to criminal sanction. It would be cruel and senseless to impose, on pain of felony charges, a duty of disclosure on Chiarella when, in a civil context, his "tippers"—the prospective tender offerors—have no such duty.

Third, this Court very recently rejected the concept that the remedial purpose of the 1934 Securities Exchange Act can serve to broadly construe its sections. In holding that a private right of action was not to be implied in Section 17(a) of the 1934 Act, this Court wrote:

> ". . . generalized references to the 'remedial purposes' of the 1934 Act will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.' " *Touche Ross & Co.* v. *Redington,* —— U.S. ——, 47 U.S.L.W. 4732, 4737 (June 18, 1979).

See also SEC v. *Sloan,* 436 U.S. 103, 116 (1978).

There being no duty of disclosure on Chiarella, his silence does not amount to a "manipulative or deceptive device or contrivance" within the meaning and intendment of Section 10(b) and Rule 10b-5.

POINT II

The Second Circuit's application of an unpredictable, novel, and expansive construction of Section 10(b) and Rule 10b-5 to affirm the conviction, violated due process.

At the time Vincent Chiarella traded in stocks on the basis and without disclosure of material nonpublic information obtained without access to the issuer, conduct such as his had never before been interpreted as within the embrace of Section 10(b) or Rule 10b-5. Identical conduct had been ruled to be without their proscription. To base its decision sustaining the conviction, the Second Circuit expansively interpreted the Rule to create a new category of "market insider": any person with "regular access to market information" (588 F.2d at 1365-66).

Had Chiarella himself or any attorney he consulted, previous to his acts, sought to determine whether they were criminally violative of the Section and Rule, he would have found that they were not. At most, conceptualizing fine spun distinctions between the status of particular categories of traders, Chiarella or his attorney might have concluded that the issue had not been resolved and that there were insufficient and conflicting criteria in existence to reasonably foresee whether the conduct was meant to be covered.

Accordingly, the application of Rule 10b-5 to Chiarella's conduct violates the fair notice requirement of due process. *Dunn* v. *United States*, —— U.S. ——, 47 U.S.L.W. 4607, 4611 (June 4, 1979); *Rewis* v. *United States*, 401 U.S. 808, 812 (1971); *Bouie* v. *City of Columbia*, 378 U.S. 347 (1964); *Lanzetta* v. *New Jersey*, 306 U.S. 451, 453 (1939).

The State of the Law at the Time of Chiarella's Acts

Chiarella's case is the first criminal prosecution for the purchase of stock on the basis of undisclosed material information. As the prosecution acknowledged, the case represents a novel application of Section 10(b). It is the first litigated case of any sort—*civil* or criminal—where a court has found liability based on the purchase of stock in a corporation about to be targeted for tender offer when the information was obtained from the offeror corporations. In sustaining the conviction, the Second Circuit deemed prior law "irrelevant" and fashioned its new "test" of liability—"regular access to market information"—suggesting that it would "provide a workable rule" as capable of "resolving close cases" in the future as was the "corporate insider" concept of *Texas Gulf Sulphur* (588 F.2d at 1365-66). That the Circuit created new law and did not merely restate or reformulate existing law is frankly conceded by Chief Judge Kaufman in his opinion when he wrote that the prosecution's theory of the Rule was based on ". . . *a view [of the law] we today hold was correct.*" 588 F.2d at 1370 n.18 (emphasis supplied).

Prior judicial treatment of the Rule demonstrates the unpredictable novelty of the Second Circuit's interpretation in the case at bar. Despite the "indefinite and uncertain disclosure obligation" (*International Brotherhood of Teamsters* v. *Daniel*, —— U.S. ——, 99 S. Ct. 790, 801 [1979]) of this rather elastic Rule it has consistently throughout its history only been applied to so-called insider cases where the material nonpublic information was derived from the issuer. The sanctions of Rule 10b-5 were never invoked without there having been access directly or indirectly to the issuer corporation and thus on the use of such informa-

tion a consequent breach of a fiduciary obligation. *See generally,* 3 L. Loss, Securities Regulation 1450-56 (2d ed. 1961); 6 L. Loss, Securities Regulation 3556-76 (2d ed. supp. 1969). From the landmark opinion in *Cady, Roberts & Co.,* 40 S.E.C. 907 (1961), where Chairman Cary defined persons covered by the broad language of the antifraud provisions as those "who are in a special relationship with a company and privy to its internal affairs . . ." (*id.* at 912) to *SEC* v. *Texas Gulf Sulphur,* 401 F.2d 833 (2d Cir. 1968), where Judge Waterman held the duty to disclose information or the duty to abstain from buying or selling securities was limited to persons (or those in privity with them) "dealing in *his* company's securities" (*id.* at 848) (emphasis supplied), access to inside information of the issuer has been the *sine qua non* for 10b-5 nondisclosure liability.

This necessity of a fiduciary nexus in situations the same as the instant one was pointedly set forth by Judge Friendly in *General Time Corp.* v. *Talley Industries,* 403 F.2d 159, 164 (2d Cir. 1969):

> "We know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and 'had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale. . . ."

And *see Radiation Dynamics, Inc.* v. *Goldmuntz, supra,* 464 F.2d 876, 890 (2d Cir. 1972) (". . . purpose of Rule . . . as we have stated time and time again, is to prevent corporate insiders and their tippees from taking unfair advantage . . .").

Commentators, too, have stated that the practice of a prospective offeror making open market purchases of shares

of a target without disclosing an impending tender offer is not violative of the Rule. *See, e.g.,* A. Bromberg, Securities Law: Fraud §6.3 (1969).

It was a fair and rational extension of the concept of non-liability of prospective offerors for Chiarella or any attorney he might have consulted to conclude that tippees of the offerors similarly were not liable. Indeed, Chiarella testified he believed that since an offeror corporation was not guilty of wrongdoing by open market purchases previous to a tender offer, a common practice of which he was aware, he was also acting in a lawful manner because he derived his information from that source (R.492). The same determination logically flows from the Williams Act (15 U.S.C. §78m [d][1]) which excuses disclosure of intention by the prospective offeror until it has accumulated a sufficient block of stock in the target to constitute it a major shareholder, and thus, a fiduciary.

In assessing the state of the law and Chiarella's actual or potential notice of it at the time of his conduct, it would be remiss to overlook Judge Meskill's vigorous dissent from the majority decision which in his view, "expands Section 10(b) drastically" and is indisputably "a departure from prior law" (588 F.2d at 1373).

Chiarella's acts at the time committed could hardly have been said to "plainly and unmistakably" fall within Section 10(b) and Rule 10b-5 where such disparate opinions even now address the issue.

Nor were the omens and portents of the policy underlying the securities laws so apparent that Chiarella might

be charged with having gleaned from them a clear and definite understanding that his future acts would be deemed criminal in nature. Aside from the wide divergence in theory as evidenced by the majority and dissenting opinions, the majority explicitly rejected the trial court's policy justification for distinguishing Chiarella from the prospective offerors (*i.e.*, the Pandick Press clients from whom he obtained his information). Thus, the trial court explained away the anomalous situation where at the same time Chiarella was liable his "tipper" was not by reference to a "presumptively legitimate business purpose" of the offeror which the trial court perceived as absent in Chiarella (450 F.Supp. at 97). The Appeals Court specifically disavowed the policy justification of the trial court and agreed with Chiarella that ". . . 'business purpose' cannot be dispositive of liability under Rule 10b-5" (588 F.2d at 1368 n.15) and justified its decision on other policy grounds.

Almost two years after Chiarella's acts upon which the indictment is predicated, the American Law Institute, in a thorough study of federal securities law, concluded that there was no "justification" in the present law "for imposing a fiduciary's duty of affirmative disclosure on an outsider who is not a tippee" such as Chiarella. American Law Institute, Proposed Official Draft of the Federal Securities Code, 538-39 (March 15, 1978). As the council and staff wrote in its submission to the Institute's members (*id.*):

> ". . . [I]t is hard to find justification today for imposing a fiduciary's duty of affirmative disclosure on an outsider who is not a 'tippee.' It would be convenient to have a new category of 'quasi-insider' that would cover people like judges' clerks who trade on information in unpublished opinions, Federal Reserve Bank employees who trade with knowledge of an imminent change in the margin rate [citations omitted], and perhaps persons who are about to give profitable supply contracts to corporations with which they are not otherwise connected, while excluding persons who have merely decided to go into the market in a big way. But all this does not lend itself to definition. It is difficult in the abstract to opine even on illustrative cases. Where, for example, would one place the outsider who is about to make a tender offer—or his depository bank?"[19]

The question of liability under Rule 10b-5 for the tippee of an "outsider" tender offeror is specifically noted by the ALI as a "question . . . left to further judicial development . . . as not ripe for codification." American Law Institute, Proposed Official Draft of the Federal Securities Code, §1603, comment 3(d), at 539 (March 15, 1978).

Criminally Prosecuting Chiarella's Conduct Violated the Fair Notice Requirement of Due Process.

Recognizing the necessary elastic quality of the Rule and its occasional rightful application to original sets of facts, still it is bluntly a violation of due process to apply it to conduct which could not have been discerned to be within the Rule. This constitutional infirmity in Chiarella's conviction is made manifest when considered in light

19. Doubtlessly, Federal Reserve employees and judges' clerks who trade on information received in the course of their employment would run afoul of Chief Judge Kaufman's formulation of the rule which would impose liability on "*Anyone*—corporate insider or not —who regularly receives material nonpublic information . . ." 588 F.2d at 1365.

of the policies underlying the Rule, its history, judicial interpretation which previously adjudicated identical conduct legal, and scholarly comment with respect to it. All these authorities support the conclusion that the Rule did not cover Chiarella's conduct. Neither may Chief Judge Kaufman's *ex post facto* interpretation add the requisite definiteness to cure the constitutional insufficiency.

A fundamental precept of our system of justice is the constitutional requirement of definiteness, that is, a criminal statute must "give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden. . . ." *United States* v. *Harriss,* 347 U.S. 612, 617 (1954). And *see, Dunn* v. *United States,* —— U.S. ——, 47 U.S.L.W. 4607, 4611 (June 4, 1979); *Rewis* v. *United States,* 401 U.S. 808, 812 (1971); *Bouie* v. *City of Columbia,* 378 U.S. 347 (1964); *Lanzetta* v. *New Jersey,* 306 U.S. 451, 453 (1939); *compare United States* v. *Naftalin,* —— U.S. ——, 47 U.S.L.W. 4574, 4577 (May 21, 1979).[20]

Bouie v. *City of Columbia, supra,* is apposite. In that case defendants were convicted under a South Carolina statute prohibiting trespass—the entry on the premises

20. In *United States* v. *Naftalin, supra,* Naftalin conceded that his conduct amounted to a "scheme to defraud" within the meaning of Section 17(a)(1) of the 1933 Securities Act and quarreled only with whether his victims—stockbrokers—were within the protected class. Since the language of the statute plainly makes fraud in connection with the offer or sale of securities unlawful without requiring that the victim be a member of any particular class, there was no genuine notice problem. In the case at bar, where the whole question is whether Chiarella's conduct amounts to fraud within the statute or rule, unlike *Naftalin,* "the words of the statute" do not "plainly impose" liability nor has "congress . . . conveyed its purpose clearly" so that real "ambiguity . . . exists" (*id.* at 4577).

of another after receiving notice not to enter. The South Carolina Supreme Court affirmed the convictions by interpreting the trespass statute to cover the act of remaining on the premises of another after receiving notice to leave. This Court reversed the convictions and held that the retroactive application of a new and expansive judicial interpretation of a criminal statute violated due process. Mr. Justice Brennan wrote (*id.* at 352-54):

> "There can be no doubt that a deprivation of the right of fair warning can result not only from vague statutory language but also from an unforeseeable and retroactive judicial expansion of narrow and precise statutory language . . . . [A]n unforeseeable judicial enlargement of a criminal statute, applied retroactively, operates precisely like an *ex post facto* law, such as Art. I, §10, of the Constitution forbids . . . . If a state legislature is barred by the *Ex post Facto* Clause from passing such a law, it must follow that *a State Supreme Court is barred by the Due Process Clause from achieving precisely the same result by judicial construction.*" (Emphasis supplied.)

The vice in the Second Circuit's opinion is precisely that of the South Carolina Supreme Court in *Bouie,* and indeed, is an even more egregious form of it. The Circuit here retroactively expanded the coverage of Rule 10b-5 to "*Anyone*—a corporate insider or not—who regularly receives market information." Yet, to construe remaining on the premises of another after receiving notice to leave as a criminal trespass is far more predictable as a common sense protection of property rights than is importing an essentially fiduciary obligation into an area where none previously existed.

The constitutional injustice to Chiarella is powerfully evidenced by the Circuit's articulation of the "test" of "regular access to market information" and its use of that circumstance to affirm his conviction. The Second Circuit's holding that "regular access to market information" is what justifies the criminal application of Rule 10b-5 is of a piece with the government argument in *Rewis* v. *United States, supra,* 401 U.S. at 814, which this Court bluntly rejected. In *Rewis,* a Travel Act prosecution, this Court held that conducting a gambling operation frequented by out-of-state bettors was not within the Act's proscription against interstate travel with the intent to promote gambling. The government urged that the conviction should be affirmed because the Act could be construed to include the operator of a gambling operation who actively attracts business from another state. Although this Court believed that there was some support for the government's argument, it refused to uphold the conviction on the basis of the government's interpretation of the Act "because it is not the interpretation of [the Act] under which petitioners were convicted." (*Id.*)

With language of especial application to this case, this Court wrote as follows in *Rewis*:

> "The jury was not charged that it must find that petitioners actively sought interstate patronage. . . . As a result, the Government's proposed interpretation of the Travel Act cannot be employed to uphold these convictions." (*Id.*)

Similarly, the jury here was not charged that it must find that Chiarella had "regular access to market information." Simply put, the factual merits of a defense argument to the jury on that issue aside, Chiarella had an absolute right to have the jury determine "every fact necessary to constitute the crime," not an appeals court after the fact. *In re Winship,* 397 U.S. 358, 364 (1970).

Nor does the Court of Appeals' reliance on signs posted by Chiarella's employer warning against the use of confidential information and the possibility of criminal liability and several civil consent decrees settling SEC lawsuits justify its finding that petitioner "manifestly had adequate notice that his trading in target stock could subject him to criminal liability" (588 F.2d at 1369). Any notice obtained from the employer's signs or from the commencement of civil lawsuits by the SEC "manifestly" does not provide the notice and predictability due process requires.

In *Bouie, supra,* this Court rejected the contention that defendants had adequate notice of the trespass violation because a chain with a "no trespassing" sign attached had been placed on the premises by an employee of the owner (378 U.S. at 355 n.5):

> "The determination whether a criminal statute provides fair warning of its prohibitions must be made on the basis of that statute itself and the other pertinent law, rather than on the basis of an *ad hoc* appraisal of the subjective expectations of particular defendants."

That the sign and the SEC's lawsuits are not "the statute itself and the other pertinent law" sufficient to provide notice is best illustrated by the Second Circuit majority's own language (588 F.2d at 1370 n.18):

"The sign merely informed appellant of the SEC's view of the law—*a view we today hold was correct.*" (Emphasis supplied.)

And with respect to the SEC's view of the law, this Court has on a number of recent occasions rejected the SEC's interpretation of various provisions of the Securities Acts. *See, International Brotherhood of Teamsters* v. *Daniel,* —— U.S. ——, 99 S.Ct. 790, 800 n.20 (1979), and cases cited therein. Further, "less formalized custom and usage" (*Parker* v. *Levy,* 417 U.S. 733, 754 [1974]) must fairly be considered to have indicated to Chiarella the legality of his conduct. As noted above, he was keenly aware of the common and accepted practice of a prospective offeror purchasing shares of the prospective target in the open market.[21]

In sum, Section 10(b) and Rule 10b-5 as applied in this case failed to meet the constitutionally requisite standards of definiteness, whether perceived "through the eyes [of Chiarella, or] . . . his lawyer" had he consulted one. *See* Note, *Due Process Requirements of Definiteness in Statutes,* 62 Harv. L. Rev. 77, 82 (1948).

21. Chiarella's knowledge that the prospective tender offerors from whom he obtained his information were trading in the target company stocks understandably engendered his belief that what he was doing was legal. Since, as in GX31F, this conduct by the prospective offerors was disclosed in the prospectuses and thus, necessarily approved by the regulatory authorities, Chiarella was entitled to believe that it had been deemed lawful by the SEC. Such a justifiable belief on his part negates his criminal intent, and his reliance on this authoritative guidance renders his prosecution violative of due process. *Cf. United States* v. *Pennsylvania Industrial Chemical Corp.,* 411 U.S. 655 (1973); *Cox* v. *Louisiana,* 379 U.S. 559 (1965); *Raley* v. *Ohio,* 360 U.S. 423 (1959).

POINT III

The trial court failed to instruct the jury on an essential element of the crime charged, namely specific intent to defraud or deceive.

Chiarella's sole defense on the merits was that he denied having an intent to defraud. Despite consistent urgings by the defense that the jury be charged that a finding beyond a reasonable doubt of intent to defraud was a predicate to conviction and despite defense requests to charge embodying that principle,[22] the court flatly refused to charge the jury that specific intent to defraud was a requisite element of the crime.

It is fundamental that a defendant is entitled to jury instructions regarding every essential element of the crime charged. In *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), this Court held that in a *civil* action for damages for violation of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j[b]) and Rule 10b-5 it is necessary to plead and prove "'scienter'—intent to deceive, manipulate, or defraud." *Id.* at 193. The Court concluded that by the use of the words "manipulative or deceptive device," in Section 10(b) congress intended to prohibit only "intentional or willful conduct *designed to deceive or defraud* investors." (Emphasis supplied.) *Id.* at 198-99.

In this *criminal* case, in an *a fortiori* violation of the rule announced in *Hochfelder,* the trial court never in-

22. *See* Chiarella's Requests to Charge Nos. 14, 18, 20, 21, 24-26; Supplemental Request to Charge No. 2(a).

structed that specific intent to defraud was an essential element. Rather, the state of mind the jury was instructed conviction could be premised on was "a realization on the defendant's part that he was doing a wrongful act" (R.688).

But a defendant's "realization . . . that he was doing a wrongful act" is functionally and theoretically remote from having a specific intent to defraud. The essential distinction between the two concepts is the element of purpose embraced in the specific intent concept. Thus, a person who "realiz[es]" he commits a "wrongful act" cannot necessarily be said to have acted with a specific purpose to defraud or deceive.

The difference is crucial in Chiarella's case. Because there was evidence that his employer had posted signs warning that use of "any information learned from customer's copy . . . will result in . . . being fired immediately . . . [and could result in] criminal penalties" (GX14A), the jury could easily have found that Chiarella "realiz[ed] . . . he was doing a wrongful act." He testified that he knew his conduct was in contravention of company policy and that he could have been fired for it (R.495). But Chiarella denied that he intended to defraud or cheat anyone (R.483-84) and the fact that his security transactions were all conducted anonymously over the open market was argued as circumstantial proof that he lacked the required specific intent to defraud the target company stockholders he never met and never dealt with (R.625-29).

Moreover, where the gravamen of Chiarella's "crime" was silence, the element of specific intent to defraud takes

on added significance. What distinguishes mere negligence based on silence or omission from the commission of a civil Rule 10b-5 violation predicated on similar conduct is the element of specific intent to defraud. *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 198-99. In a *criminal* Rule 10b-5 prosecution which obviously can never be based on negligence, it was particularly important for the jury to have been instructed to acquit unless they found that behind Chiarella's silence was a specific purpose to defraud or deceive.

The Second Circuit panel majority held that the trial court "correctly refused to charge the jury that the Government must prove specific intent to defraud" because the trial court charged the jury not to convict unless it found that Chiarella acted "knowingly" and "willfully" and defined those terms to mean "a realization on the defendant's part that he was doing a wrongful act . . ." (588 F.2d at 1370-71). Citing *United States* v. *Peltz,* 433 F.2d 48, 54-55 (2d Cir. 1970), *cert. denied,* 401 U.S. 955 (1971) and *United States* v. *Dixon,* 536 F.2d 1388, 1395-97 (2d Cir. 1976), the Court of Appeals reasoned that the language of the charge had been specifically approved for prosecutions, as was the instant one, brought under Section 32(a) of the 1934 Act (15 U.S.C. §78ff[a]).

In neither *Peltz* nor *Dixon* did the court deal at all with the intent requirement in a Rule 10b-5 case.[23] Both *Peltz* and *Dixon* (which in any event are pre-*Hochfelder*) deal

23. *Peltz* and *Dixon* simply cannot be read as having any bearing on the mental element required for there to be a Section 10(b) and Rule 10b-5 violation. Indeed, in *Peltz* the court was dealing with a Section 10(a) and Rule 10a-1(a) violation and in *Dixon* at issue were Section 14(a), Rule 10a-3 and Section 13.

exclusively with Section 32(a)—the general penalty provision of the 1934 Act which makes criminal any *willful violation* of any section of the Act or any rule or regulation thereunder "the violation of which is made unlawful."[24] Once another section of the Act or rule or regulation thereunder makes conduct "unlawful," Section 32(a) punishes such conduct as criminal where there is a "willful violation" of that other section or rule or regulation. Thus, a purely civil violation of a section, rule or regulation is transformed into a criminal one by proof beyond a reasonable doubt of all the essential elements required by the particular section, rule or regulation *including the requisite mental element, and in addition* establishing under Section 32(a) that the violation was "willful."

This Court in *Hochfelder* made clear that the requisite mental element for a Rule 10b-5 violation is the specific "intent to defraud." The trial court's error in charging the jury was that while it permitted the jury to find "willfulness" under Section 32(a) and the *Peltz* and *Dixon* formulation of "a realization of a wrongful conduct," it never charged the jury that a violation of Section 10(b) and Rule 10b-5 required proof of a specific "intent to defraud."

The trial court's *Peltz* and *Dixon* charge on willfulness did not and could not replace a *Hochfelder* charge on intent to defraud. A properly instructed jury should have been told *both* that intent to defraud was required before a

24. Thus, Section 32(a) provides:

"Any person who willfully violates any provision of this chapter . . . or any rule or regulation thereunder the violation of which is made unlawful . . . shall [be punished for a crime]."

Section 10(b) and Rule 10b-5 violation could be found and that if found, such violation was a crime if determined to be a willful violation, *i.e.*, that the defendant committed the violation with a realization that he was engaged in wrongful conduct.[25]

POINT IV

Chiarella's statement to the New York Department of Labor was inadmissible under Rule 501 of the Federal Rules of Evidence since the federal legislative, judicial and constitutional interests clearly favor and support the statutory privilege accorded the statement by the State of New York.

In an effort to alleviate pressing financial burdens, Chiarella sought unemployment compensation from the State of New York. During the course of processing his claim he was told to supply a statement setting forth the reasons he was discharged by his last employer and he complied with a complete and accurate account of how he came to lose his job:

> "I was discharged for violations of the company rules re: disclosure of client information. The allegation is true. It was a matter of printing of stock tender offers and I utilized the information for myself. This hap-

25. To be sure, "intent to defraud" may embrace "willfulness" thereby obviating the necessity of charging the latter separately. But the converse is not true—willfulness does not include "intent to defraud." In any event, since intent to defraud was not charged, the issue of whether intent to defraud embraces willfulness and therefore whether both need to be charged is not before the Court. Insofar as *United States* v. *Charnay*, 537 F.2d 341 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976) can be read for the proposition that "awareness of wrongdoing" satisfies the *scienter* requirement of Section 10(b) and Rule 10b-5, the case is in direct conflict with *Hochfelder*.

> pened last year and through investigation by the SEC, the matter came to light and I was discharged" (transcript of proceedings, April 3, 1978, pp. 1-24–1-28).

This statement was, under the express terms of a state statute, privileged and inadmissible in "any" court proceeding. These unequivocal legislative assurances, however, proved impotent, for within a few months a federal prosecutor subpoenaed Chiarella's signed statement and at his ensuing federal trial, over objection, paraded it before the jury as Chiarella's guilty plea (R.275).

A statement procured in this manner has no place in a federal criminal trial and should have been excluded. While Rule 501 of the Federal Rules of Evidence vests the federal criminal courts with power to formulate their own law on privileges, it also requires the courts to exercise that power after a review of federal and state interests involved in the particular claim of privilege before it. Both federal and state interests strongly favor preserving the confidentiality of the statement made by Chiarella. The admission of that statement was therefore error and given the pervasive prejudicial effect of its admission, one of sufficient magnitude to require reversal.

The State of New York mandates, in no uncertain terms, confidentiality of information provided in connection with a claim for unemployment insurance. New York Labor Law, §537 provides, as it has for over 40 years, that "information" acquired from employers or employees pursuant to the law shall be for the "exclusive use" of the commissioner "and shall not be open to the public."[26] The legislature, reaffirming the confidential and privileged nature of these communications, specified that the information so acquired shall not "be used in any court in any action or proceeding pending therein" except those actions or proceedings in which the Commissioner of the Department of Labor was a party. The legislature's commitment to this policy is underscored by its decision to punish any unauthorized disclosure of the information as a misdemeanor. The plain and explicit wording of the statute which, despite frequent legislative attention[27] has remained intact, demonstrates New York's resolve to keep the information it acquires under the law confidential and to bar its admission into evidence.

In recognition of the purposes sought to be accomplished by this explicit legislative command, the executive and judicial branches of the state have uniformly enforced the privilege created by §537. The statute, as one court put it, provided "for a positive nondisclosure of the communication . . . in court or out of court," a provision described as embodying either a "common-law variety of absolute privilege" or "a statutory privilege" with respect to the communications covered by the statute. *Coyne* v. *O'Connor*, 204 Misc. 465, 466, 121 N.Y.S. 2d 100, 101 (Sup. Ct. Nassau Co. 1953). And the underlying objective of the privilege was ably stated by the State's Attorney General. Appear-

26. The statute at the time Chiarella made his statement is set out at p. 4, *ante*.

27. The nondisclosure and penalty provisions have remained the same since 1935 when the statute (then §524 of the N.Y. Labor Law) was originally enacted (L. 1935, chap. 468, §1). Subsequent amendments to that law did not affect this language. See L. 1936, chap. 117, §9; L. 1938, chap. 266, §9; L. 1939, chap. 662, §21. In 1944, the legislature reenacted the nondisclosure provisions as Section 537 of the Labor Law (L. 1944, chap. 705, §1) and thereafter amended that section three times, each time without any change in the confidentiality provisions. See L. 1947, chap. 115, §2; L. 1948, chap. 346, §1; L. 1978, chap. 545, §5.

ing in *Coyne* as *amicus curiae* in support of a private party's assertion of the privilege, he argued "for the need of absolute privilege to cover communications such as that of the defendant [a statement of reasons for discharging plaintiff] to expedite the work of the department and encourage full and free disclosures by employers." *Id.*[28]

Consistent with the letter and spirit of the statute, the courts have time and again sustained assertions of the privilege. Information acquired from both employer and employee has been found to be privileged. *Graham* v. *Seaway Radio, Inc.*, 28 Misc. 2d 706, 216 N.Y.S. 2d 52 (Sup. Ct. Jefferson Co. 1961); *Breuer* v. *Bo-Craft Enterprises, Inc.*, 8 Misc. 2d 736, 170 N.Y.S. 2d 631 (Sup. Ct. N.Y. Co. 1957); *Coyne* v. *O'Connor, supra; Eston* v. *Backer*, 204 Misc. 162, 119 N.Y.S. 2d 273 (Sup. Ct. Queens Co. 1953); *Andrews* v. *Cacchio*, 264 App. Div. 791, 792, 35 N.Y.S. 2d 259, 260 (2d Dept. 1942); *see Conigliaro* v. *New Hampshire Fire Insurance Co.*, 8 Misc. 2d 164, 171 N.Y.S. 2d 731 (Sup. Ct. Kings Co. 1956).

In short, the statement which Chiarella made to the state agency would not have been admissible in evidence against him in any state court action. Chiarella's response detailing the reasons for his discharge was "information acquired from an employee" by the state in an effort to

28. The New York statute created what one commentator terms an "encouragement-type" privilege,

> "designed to encourage citizens to accurately report potentially self-damaging information which they would otherwise hesitate to furnish for fear of the consequences resulting from later uses of such information. While the ultimate beneficiary of this privilege is, of course, the government (in that it receives more accurate information), the privilege is basically designed to protect the immediate interests of the reporting citizen, and thus the privilege is personal, belonging to the reporter [footnote omitted]." Note, *The Required Report Privileges*, 56 Nw. U.L. Rev. 283, 286 (1961).

determine his claim for unemployment benefits and "information" has been held to include an employee's statements made in the course of processing a claim for benefits. *Andrews* v. *Cacchio, supra.* So long as the commissioner is not a party to the action in which the information is to be introduced, that information would be privileged and, upon objection, could not be introduced against Chiarella in the state courts of New York.

The criteria for determining whether this state privilege will be honored in the federal courts are set out in the Federal Rules of Evidence. Federal courts, according to Rule 501,[29] are required to apply the state law of privilege in civil actions where "the State law supplies the rule of decision" "with respect to an element of a claim or defense." In all other actions tried in federal courts the privilege of a witness, assuming it is not one provided for by the federal Constitution, act of Congress, or this Court's rules, "shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience."[30] Simply stated, in other than civil diversity cases, the federal court is required to evolve its own body of privilege law with established federal common law as a guide.

In this case, however, the federal common law as it has developed thus far provides no dispositive answer to the issue at hand. To be sure, there are instances in which

29. The full text of Rule 501 can be found at p. 4, *ante*.

30. The House Committee Report accompanying the draft of Rule 501, eventually enacted into law, discloses that this standard for assessing privilege claims in federal question cases was derived from Rule 26 of the Federal Rules of Criminal Procedure [H.R. Rep. No. 650, 93d Cong. 1st Sess. 8 (1973)] which was itself derived from the standard first announced by this Court in *Wolfle* v. *United States*, 291 U.S. 7, 12 (1934) and *Funk* v. *United States*, 290 U.S. 371 (1933).

federal courts, in federal question cases, have respected the privileged status of information provided to state agencies under a specific state statutory assurance of nondisclosure,[31] but there are examples to the contrary.[32] In any event, these federal cases involved statutory enactments whose language and underlying purposes vary considerably; they are therefore of little assistance in assessing Chiarella's claim. Turning to those reported federal cases addressing §537, we find only two. In *Simpson* v. *Oil Transfer Corp.*, 75 F.Supp. 819 (N.D.N.Y. 1948) invocation of the privilege was sustained and in *Vazquez* v. *Bull*, 91 F.Supp. 518 (S.D.N.Y. 1950) the court, expressly approving of *Simpson*, found the information sought to be disclosed was not "acquired from an employer or employee" and therefore outside the privilege. Thus, Chiarella's claim of privilege finds support in whatever federal law does exist and while those cases may not be dispositive of the issue, the privilege cannot be described, as the Second Circuit did, as one "unknown" to the federal common law (588 F.2d at 1372). Where, as here, the case law discloses no clear-cut answer, a federal court must reexamine the specific privilege asserted with an eye towards the development of federal privilege law. *E.g., In re Grand Jury Impaneled January 21, 1975, supra; see United States* v. *Allery*, 526 F.2d 1362, 1366 (8th Cir. 1975).

31. *Herman Brothers Pet Supply, Inc.* v. *N.L.R.B.*, 360 F.2d 176 (6th Cir. 1966); *In re Valecia Condensed Milk Co.*, 240 F. 310 (7th Cir. 1917); *Bearce* v. *United States*, 433 F.Supp. 549 (N.D. Ill. 1977); *Tollefsen* v. *Phillips*, 16 F.R.D. 348 (D. Mass. 1954); *In re Reid*, 155 F. 933 (E.D. Mich. 1906).

32. *In re Grand Jury Impaneled January 21, 1975*, 541 F.2d 373 (3d Cir. 1976); *United States* v. *Thorne*, 467 F.Supp. 938 (D. Conn. 1979); *United States* v. *Blasi*, 462 F.Supp. 373 (M.D. Ala. 1979); *United States* v. *King*, 73 F.R.D. 103 (E.D.N.Y. 1976).

The federal court's obligations in this regard can be understood only in light of the stormy history of Rule 501. Unlike most of the other federal rules of evidence, Rule 501 was the creation as well as the enactment of congress. The vast majority of the rules proposed by the Advisory Committee eventually made their way into the present Rules of Evidence. One noticeable exception was Article V, which, as drafted by the Committee, contained thirteen specific privilege rules intended to apply uniformly in all federal actions, civil and criminal, diversity and federal question. Rules of Evidence for the United States Courts and Magistrates, 56 F.R.D. 183 (1972) [hereinafter cited as "Proposed Rules"]. When presented for congressional approval, controversy regarding Article V prompted a legislative redrafting of the federal rules on privileges which resulted in the present form of Rule 501.

There were two basic points over which congress and the Advisory Committee disagreed. The Advisory Committee, convinced that privileges, like the other rules of evidence, were purely procedural, was desirous of establishing a uniform rule of privilege for all federal courts. It promulgated federal rules of evidence which, with two exceptions,[33] paid no heed to state-created privileges. Congress unequivocally rejected this premise. Concerned that rules of privilege involved important policy considerations, congress required the federal courts to respect state-created privileges and the policy determination underlying them in all cases where state law provided the rule of decision.

33. The first, proposed Rule 502, is of particular significance since it directed federal courts to honor state "required-reports" privileges. The second, set out in proposed Rule 510, recognized a state's assertion of the informer privilege. Proposed Rules, *supra*, 56 F.R.D. at 203-4, 255-56.

H.R. Rep. No. 650, 93d Cong. 1st Sess. 8 (1973). Although still free to adopt the Advisory Committee's specific rules of privileges for use in all federal question cases, congress did not. Faced with criticism of the Committee's codification due to its failure to incorporate several of the well-known privileges and its narrow interpretations of others, congress directed the district courts to develop privilege law under a uniform "standard" applicable both to civil and criminal cases. A flexible approach to the federal law of privilege replaced the proposed codification. The federal courts, when not directed to follow the law of the state, were given the responsibility to evolve a federal law of privilege on a case-by-case basis rather than required to interpret the specific rules proposed by the Committee.[34]

The legislative history of Rule 501 would not be complete without noting that congress took pains to point out that it did *not* reject the specific privileges promulgated by the Committee. The Report of the Senate Committee on the Judiciary explicitly stated:

> "It should be clearly understood that, in approving this general rule as to privileges, the action of Congress should not be understood as disapproving any recognition of a psychiatrist-patient, or husband-wife, or any other of the enumerated privileges contained in the Supreme Court rules. Rather, our action should

34. Detailed discussions of the legislative turmoil concerning Article V of the Rules of Evidence can be found in several commentaries. 2 J. Weinstein & M. Berger, Weinstein's Evidence §501 [01]-501[05], 501-12-501-49 (3d ed. 1977) [hereinafter cited as "Weinstein's Evidence"]; 2 D. Louisell & C. Mueller, Federal Evidence §§200-201, 389-429 (1979) [hereinafter cited as "Federal Evidence"]; Schwartz, *Privileges Under the Federal Rules of Evidence—A Step Forward?* 38 U. Pitt. L. Rev. 79 (1976); Note, *The Proposed Federal Rules of Evidence: Of Privileges and the Division of Rule Making Power*, 76 Mich. L. Rev. 1177 (1978).

> be understood as reflecting the view that the recognition of a privilege found on a confidential relationship and other privileges should be determined on a case-by-case basis." S. Rep. No. 1277, 93d Cong. 2d Sess. 6, 13 (1974).

Nor is this a surprising statement since the federal rules of evidence were the product of years of work by respected practitioners, jurists, and legal scholars. The rules went through several drafts, with the Committee consulting a broad spectrum of legal opinion. Accordingly, the rules promulgated by the Commitee and approved by the Court provide guidance to courts in the development of federal privilege law.[35]

Seen in this light, the test set out in Rule 501 can be succinctly stated. Whether a federal court should grant or withhold an evidentiary privilege requires it to balance competing policies. *United States* v. *Nixon*, 418 U.S. 683, 705 (1974). Consistent with congress' explicit concern for the social objectives sought to be achieved by the creation of privileges, courts must identify the nature and importance of those objectives. Where there is an assertion of a state-created privilege, the identification of those societal goals is facilitated by resort to state law. The court must also assess the federal interests for and against recognition of the privilege since recognition of the asserted privilege under Rule 501 is ultimately a question of federal law. The decision to honor a claim of state

35. While the vast majority of cases and comments share this view, the present significance of the proposed rules is still being debated. *Compare e.g., United States* v. *Mackey*, 405 F. Supp. 854, 857-58 (E.D.N.Y. 1975) *with SCM Corp.* v. *Xerox Corp.*, 70 F.R.D. 508, 522 (D. Conn. 1976). And *compare* Note, *The Proposed Federal Rules of Evidence: Of Privileges and the Division of Rule Making Power*, 76 Mich. L. Rev. 1177, 1179 (1978) *with* 2 Federal Evidence, *supra* at §202, 428-29.

privilege in a federal court will eventually depend upon a careful balancing of these various interests.

The cases which have sought to apply Rule 501 to a claim of state privilege have made their determinations in accord with this analysis. *E.g., United States* v. *Gillock,* 587 F.2d 284 (6th Cir. 1978), *cert. granted,* 47 U.S.L.W. 3740 (May 14, 1979); *In re Special April 1977 Grand Jury,* 581 F.2d 589, 592-93 (7th Cir.), *cert. denied,* 99 S.Ct. 721 (1978); *In re Grand Jury Proceedings,* 563 F.2d 577, 582-85 (3d Cir. 1977); *In re Grand Jury Impaneled January 21, 1975,* 541 F.2d 373 (3d Cir. 1976); *United States* v. *Allery,* 526 F.2d 1362 (8th Cir. 1975); *Gulliver's Periodicals, Ltd.* v. *Chas. Levy Circulating, Inc.,* 455 F.Supp. 1197 (N.D. Ill. 1978); *United States* v. *King,* 73 F.R.D. 103 (E.D.N.Y. 1976). And the texts dealing with the new federal evidence rules have uniformly urged the courts to apply a similar analysis. 2 Federal Evidence, *supra* at §201, 411-429; 2 Weinstein's Evidence, *supra* at §501[02], 501-17-501-20.5.

Application of these principles to the instant case strongly supports Chiarella's claim of privilege. We have already discussed the unambiguous language of New York's Labor Law, the underlying advantages to both the individual and the state by granting this privilege, and the rigorous enforcement of the privilege in the state courts. Chiarella's case provides a perfect illustration of how that very policy was effectuated. When directed to explain why he had been fired, his answer was anything but evasive. The state had the accurate information it desired without the necessity of applying its scarce resources for an investigation of the applicant. Suffice it to say, the State of New York has decided that the public

benefit derived from acquiring complete and accurate information needed for the effective administration of its unemployment insurance program outweighs the loss of such reported information in its courts. This legislative judgment should, absent a compelling federal interest, be honored by the federal courts. *See* Krattenmaker, *Testimonial Privilege in Federal Courts: An Alternative to the Proposed Federal Rules of Evidence,* 62 Geo. L.J. 61, 117 (1973).

The federal interests in preserving the confidentiality of Chiarella's statement are closely allied if not directly responsible for the privilege provided by the New York statute. The federal government, in accord with the practice of many states, has, for the same reasons as New York,[36] provided assurances of nondisclosure for those who are required to report information to various federal agencies. *E.g.,* 42 U.S.C. §1306 (Social Security returns); 42 U.S.C. §2000E-5(a) (Conciliation attempts of the Equal Employment Opportunities Commission); 38 U.S.C.A. §3301 (1972) (files and records relating to claims under the Veterans' Administration).[37] Such federally acquired information shielded by an "Act of Congress" would, of

36. This Court, in discussing one such federal regulation prohibiting the use of Internal Revenue records, identified the public policy considerations underlying it:

> "The interests of persons compelled, under the revenue law, to furnish information as to their private business affairs would often be seriously affected if the disclosures so made were not properly guarded." *Boske* v. *Comingore,* 177 U.S. 459, 469-70 (1900).

37. A list of the numerous federal statutes insuring confidentiality of the information supplied to any number of federal agencies is set forth in 2 Federal Evidence, *supra* at §202 Appendix, 445-60. A sampling of state statutes which serve similar purposes can be found in 8 J. Wigmore, Evidence §2377 (McNaughton Rev. 1961).

course, be inadmissible in a federal criminal or civil trial by the plain wording of Rule 501. *See United States* v. *Caserta,* 199 F.2d 905, 910-11 (3d Cir. 1952).

Where the federal government administers its own unemployment insurance plan (Railroad Unemployment Insurance Act, 45 U.S.C. §351 *et seq.*) it, too, grants confidentiality to the information it receives (45 U.S.C. §362[d])[38] so as to protect the privacy and identity of the reporter. But not only do the federal and New York State legislatures share the same commitment to preserving privacy in the area of unemployment insurance information, the federal government has also manifested its keen interest that all states pass similar laws. Under 26 U.S.C. §3304(a)(16) and (17), a state unemployment insurance statute, in order to meet minimum federal requirements, must provide "safeguards to insure that information [obtained by the state through administration of the state law]" is used solely for the administration of that law and that all privileges conferred by the state statute shall remain in existence.[39]

38. In words reminiscent of the New York Labor Law, 45 U.S.C. §362 provides:

> "(d) Information obtained by the Board in connection with the administration of this chapter shall not be revealed or open to inspection nor be published in any manner revealing an employee's identity: . . ."

Congress goes on to provide three limited exceptions but none of them would have authorized the Board to disclose the information it had obtained to a federal prosecutor.

39. In so doing, the federal government has demonstrated that its interests are directly served by a state statute which, by granting confidentiality, encourages accurate and complete reporting. Surely if this information promotes the efficient administration of state agencies which are required to report to their federal counterparts, the efficient administration of those federal agencies must be furthered by protecting the confidentiality and accuracy of such information.

In this manner the federal government has powerfully demonstrated the strong federal policy in favor of granting confidentiality to required reports in general and unemployment insurance information in particular. The parallel state and federal policies regarding precisely the same subject must weigh heavily against overriding the state privilege when asserted in federal court. Similar comparisons led one court to conclude that a state privilege should be recognized in a federal prosection, reasoning that "principles of federal-state comity—'a proper respect for state functions,' *Younger* v. *Harris,* 401 U.S. 37, 44 . . . (1971), reinforce this conclusion." *In re Grand Jury Proceedings, supra,* 563 F.2d at 583. For the federal government to actively encourage states to provide for confidentiality of required information and then fail to enforce those privileges when threatened in federal courts does not show "proper respect for state functions."

Moreover, there is additional strong indication from non-legislative sources of the federal commitment to respect a state "required-report" privilege in a federal case. Proposed Rule of Evidence 502 as approved by this Court would have required the district court to exclude Chiarella's statement.[40] This proposed rule and the policy behind

40. Proposed Rule 502 provided:

> "A person, corporation, association, or other organization or entity, either public or private, making a return or report required by law to be made has a privilege to refuse to disclose and to prevent any other person from disclosing the return or report, if the law requiring it to be made so provides. A public officer or agency to whom a return or report is required by law to be made has a privilege to refuse to disclose the return or report if the law requiring it to be made so provides. No privilege exists under this rule in actions involving perjury, false statements, fraud in the return or report, or other failure to comply with the law in question." 56 F.R.D. at 234-35.

it argue for sustaining the privilege in this case. One reason is that this rule was not at the heart of the controversy which surrounded the other proposed rules of privileges. It is also very significant in that it represents the one major area where the Advisory Committee, otherwise unconcerned with state law, recognized that state "required reports" statutes "embody policies of significant dimension," and specifically required a federal court to apply state law when it contained such a privilege. Proposed Rules, *supra,* 56 F.R.D. at 235.[41] The confluence of these factors justifies reliance on proposed Rule 502 as declarative of a federal policy in favor of federal recognition of the privilege guaranteed by the New York Labor Law.

The strong federal constitutional policy which underlies the Fifth Amendment's right against self-incrimination also favors recognition of Chiarella's privilege in the federal courts. Legislative enactments which require the applicant to make statements as a condition to the receipt of certain fundamental benefits, like unemployment compensation, raise the spectre of compelled self-incrimination. The Advisory Committee note accompanying its draft of proposed Rule 502 clearly recognized the constitutional

41. As one member of the Advisory Committee stated:

"By preserving state privileges for required reports, Standard 502 recognizes that the public benefit derived from acquiring fuller and more accurate information which is needed for effective governmental functioning 'outweighs the loss of the reported information to the federal court.' [Footnotes omitted.]" 2 Weinstein's Evidence, *supra* at §502[02], 502-4.

See Note, *Federal Rules of Evidence and the Law of Privileges,* 15 Wayne L. Rev. 1287, 1302-04 (1969).

considerations which necessitate the "required reports" privilege:[42]

> "A provision against disclosure may be included in a statute for a variety of reasons, the chief of which are probably assuring the validity of the statute against claims of self-incrimination, honoring the privilege against self-incrimination, and encouraging the furnishing of the required information by assuring privacy." 56 F.R.D. at 235.

In accord are four members of this Court who, dissenting from a plurality opinion, have recognized that a California statute requiring a citizen to furnish information about a traffic accident violates the Fifth Amendment's prohibition against self-incrimination. *California* v. *Byers,* 402 U.S. 424, 459-78 (1971) (Black, Douglas, Brennan, and Marshall, JJ., dissenting).

Where, as here, the state legislature has removed the danger of self-incrimination with an express proscription against the information it acquires being used in court, that use proscription should, following the dictates of the Fifth Amendment, be enforced in the federal courts. In *Murphy* v. *Waterfront,* 378 U.S. 52 (1964), this Court held that when a state grants one of its citizens "use" immunity and the citizen provides information, the grant is binding on the federal authorities and the information may not be used in any subsequent federal criminal prosecution.

This impressive array of federal interests which support recognition of the privilege in a federal tribunal

42. The Fifth Amendment implications with respect to the government's use of Chiarella's statement were raised by the defense motion for a hearing to test the voluntariness of this statement. The motion was denied without the requested hearing (R.245-48).

surely overrides any federal interest which even arguably supports a different result. There is, as the Second Circuit observed in affirming Chiarella's conviction, a "strong federal policy favoring admissibility in criminal cases" (588 F.2d at 1372), but this policy has no application to this case. The truth-determining process at Chiarella's trial would not have been perverted by the exclusion of Chiarella's privileged statement. The statement, while it had a definite and negative impact on the defense, did not significantly add to the government's evidence. The fact that Chiarella had been fired for violating his employer's policy, was amply demonstrated by other government proof. Indeed, Chiarella's statement is now considered by the government to be "cumulative" evidence of guilt which in its view "could not have affected the result" (Gov. Brief in Opposition to Petit. for Cert. at 11). In short, the federal interest in providing a fact-finder with all relevant evidence does not, in this case, offer a compelling reason to override a privilege which furthers social objectives deemed important by federal and state legislatures, not to mention the United States Constitution.

The prejudicial impact of the district court's failure to sustain the defense's repeated objections to the government's use of this evidence is readily apparent. While the government has continuously labeled any error as harmless due to the claimed cumulative nature of the proof supplied by Chiarella's statement, this argument ignores the dramatic impact of a written confession on the jury. Moreover, the prosecution made sure to highlight the prejudicial impact of this evidence. It not only introduced the confession on its direct case (GX 12; R.275-

77), but also used it to cross-examine the defendant when he testified and made substantial use of it again in summation (R.513-16, 611-14, 659-60). Equally important, however, was the statement's serious consequences on the defense. As trial counsel informed the court, "I feel constrained to advise [Chiarella] to [take the stand] in light of the fact that the statement from the State Unemployment Board was admitted into evidence" (R.334-35). In fact, this Court has itself recognized the powerful effect an improperly admitted statement may have on a defendant's decision to waive his Fifth Amendment rights and testify at trial. *Harrison* v. *United States*, 392 U.S. 219, 223-26 (1968).

Thus, on this record, the erroneous introduction of Chiarella's statement was no mere technical defect which can or should be disregarded. The error profoundly affected the defense and the jurors' deliberations as well.

Conclusion

For the above reasons, the judgment of the Court of Appeals for the Second Circuit should be reversed with instructions to dismiss the indictment.

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Respectfully submitted,

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